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E.O. 12958: N/A
TAGS: ECON EFIN ELAB IT KPRP
SUBJECT: SINISCALCO UNVEILS ITALY'S CONTROVERSIAL FOUR-YEAR FINANCIAL PLAN: THE FIRST ACT OF THE POST-TREMONTI ERA

REF: ROME 2836

Summary

¶1. The July 29 release of Italy's four-year economic blueprint opens Italy's annual budget process. The release follows the political turmoil surrounding Finance Minister Tremonti's resignation and the appointment of the new Minister Siniscalco. The DPEF, which sets budgetary guidelines for the next four years and makes projections about economic performance, has, as usual, triggered controversy - this year, over the enormous size of the projected deficit reduction package for FY 2005 and how that package might depress the already slow-growing economy in
¶2005. (This would be the toughest deficit reduction package since 1993.) However, in a more collaborative way than the controversial Tremonti would have used, Siniscalco has reached out to Coalition parties, local government officials, unions, and the employers' association to discuss the size and the shape of the huge euro 24 billion (roughly USD 31 billion) deficit reduction package for 2005.

¶2. The good news is that the 2005-2008 DPEF is based on conservative assumptions and addresses the need for structural reform. (Seventy percent of the deficit reduction package results from structural changes, while only a modest thirty percent will continue Tremonti's tradition of one-time measures.) The DPEF also includes a sound GOI plan to privatize (sell off) key State-owned business to bring down the current 106.2 percent debt-to-GDP ratio to 100 percent by end-2007.

¶3. The bad news is that the GOI frankly admits in the DPEF that Italy cannot balance its budget before 2008, since GDP growth rates may range only from 1.9 to 2.1 percent in the four-year period.

¶4. Parliament "reviewed" the DPEF August 3, but does not need to approve it. The next step in the budget process will be Siniscalco's release of the draft 2005 budget in September. End summary.

The Basic Facts: DPEF 2005-2008

¶5. On July 29, the Cabinet approved the 2005-2008 DPEF (Documento di Programmazione Economica e Finanziaria) a four-year economic plan outlining economic/budgetary goals for each year through 2008. While not binding, the DPEF previews the 2005 budget to be presented to Parliament late-September. Finance Minister Siniscalco briefed the Cabinet on the DPEF. On the budget deficit, he admitted that because the 2005 deficit would be 4.4 percent of GDP (above the three percent European Monetary Union (EMU) ceiling), Italy would need a euro 24 billion deficit reduction package to reduce the 2005 deficit/GDP ratio to 2.7 percent. He described the euro 24 billion package as including euro seventeen billion in spending cuts and euro seven billion in one-time revenue measures. Should a tax reduction package go forward, he said, those tax cuts would produce another euro twelve billion budget shortfall.

¶6. On tax cuts, it appears Siniscalco has been able to win political support for his idea not to institute them in
¶2005. The plan to lower tax rates, reduce the number of tax brackets from six to three, and reduce the IRAP (the regional tax on value-added business income) is mentioned in the DPEF, but these changes are planned for 2006.

¶7. The key goals of the DPEF are:

-- structural change of public accounts;

-- policies to support growth;

-- sustainable public debt reduction to increase the

credibility of GOI financial policy;

-- macroeconomic/financial policies in line with European Stability and Growth Pact commitments;

-- real GDP growth of 1.9 percent in 2005, increasing gradually to 2.1 percent in 2007-8;

-- steady reduction of Italy's high debt from 106.2 percent of GDP in 2004 to 98.8 percent in 2008 through privatization/sale of euro 100 billion of State-owned assets over the next four years;

-- a 2005 euro 24 billion deficit reduction package, of which euro 17.0 billion represents spending cuts and euro 7.0 billion are one-time measures. (Note: there are large, but less draconian, budget reductions in subsequent years: euro 13.7 billion in 2006; euro 7.3 billion euro in 2007; and euro 6.0 billion in 2008. These annual packages total euro 51 billion, of which euro 44 billion are spending cuts. This plan is consistent with the GOI agreement with the EU Commission and ECOFIN to limit one-time measures to no more than one-third of the overall budget reduction package. End note.)

-- Predictions of inflation to decrease from 2.4 percent in 2004 to 2.1 percent in 2008;

-- Increased GOI investment (euro 20 billion over the four-year period) to encourage productivity and competitiveness in Italy' key sectors;

-- Lowering of tax rates, reducing the number of tax brackets from six to three in 2006, and reducing IRAP (the regional value-added business income tax).

Most Assumptions and Numbers Are Realistic.

¶8. This is the first DPEF that does not bet on economic recovery, and the assumptions seem realistic. Siniscalco's 2005 GDP growth target of 1.9 percent is in line with the latest consensus forecast that assumes a 1.8 percent growth next year. In addition, the GDP growth predictions for the next three years (ranging from 2.0 percent to 2.1 percent) also seem realistic. As Siniscalco explained to the unions, "our numbers are conservative."

But One Heavily-Politicized Figure Is in Dispute.
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¶9. The one figure in dispute is "target" inflation, which the GOI set at 1.6 percent in 2005 - some fifty basis points below the latest consensus estimates (2.1 percent and 2.0 percent, respectively). The GOI "target" inflation rate is extremely important, because it provides the reference inflation rate for labor contract renewals. According to the Finance Ministry, the target inflation rate must be lower than the real projected inflation rate to avoid the inflationary effect of any subsequent wage increases. The unions are pressing for a target inflation rate as close as possible to the projected real inflation rate in 2005: 2.2 percent. If that 1.6 percent figure does not change, they have announced protests and demonstrations this fall.

Prospects for Further Privatization

¶10. The DPEF does not specify which spending cuts and revenue-raising measures the Government will propose in the 2005 budget, but does provide detail on a Government plan to raise euro 100 billion over the next four years by selling off state-owned firms to help reduce the debt/GDP ratio from the current 106.1 to somewhere below 98.8 percent in 2008.

¶11. Comment: As market conditions improve, we expect the GOI to begin again to sell off assets. So far, the GOI has been

reluctant to sell shares in firms in sectors considered critical to national security, such as aerospace and defense. Thus, the GOI will likely retain its 32.3 percent stake in Finmeccanica (the large aerospace and defense holding company) and the 30 percent stake in ENI (Italy's largest hydrocarbon company).

¶12. The first privatization will be the sale of 10-20 percent of Enel, Italy's main electrical producer, in October. The sale is expected to produce revenue ranging from euro 4 to 8 billion and to reduce the GOI's current 67 percent stake in Enel. In addition to the Enel sale, the

State might also consider reducing its current 100 percent-ownership in both Ferrovie dello Stato (railway services) and Poste Italiane (postal services). End Comment.

Siniscalco Silences Some Critical Voices, but Not All.

¶13. Last year's DPEF release led to a months-long squabble between Finance Minister Tremonti and Central Bank Governor Fazio. However, there has been no public comment (or criticism) of the 2004 DPEF by the Central Bank, one reason for which might be Siniscalco's more collaborative approach and his insistence on dialogue among those groups most affected by budget decisions to seek to gain their confidence.

¶14. Siniscalco has extended this collaborative approach to both the unions and the employers' association (Confindustria), and - in a novel approach -- has asked both to e-mail him their comments and suggestions at a specially-established email address DPEF@tesoro.it.

¶15. Nonetheless, the unions have reacted coolly to the plan, despite the GOI offer to discuss the labor issues contained in the DPEF. Guglielmo Epifani, the Secretary General of the powerful left-wing union federation CGIL, expects the four-year plan to "affect workers, pensioners and firms," all of whom he says have already paid the consequences of the economic crisis. He also notes union dissatisfaction with the Government's decision on a target inflation rate. On tax cut proposals, the unions suggested - but have not yet received - confirmation that cuts would be weighted toward lower-income workers, and would be accompanied by a plan to attack the endemic problem of tax evasion.

¶16. Confindustria (employers' association) President Luca Cordero di Montezemolo lent his support for budget discipline because without it, "Italy risks loss of confidence in the financial markets," further expenses in servicing public debt, and then another drag on economic growth. However, he called for more investment both in the south and in R&D. On the tax cut issue, he pressed for reduction of IRAP, the regional value-added business income tax, since it is "the heaviest tax (drag) on growth of the national product."

What About the 2005 Budget?

¶17. Siniscalco is now preparing the 2005 euro 24 billion deficit reduction package, but there is no word yet on what one-time revenue measures or budget cuts might make up that package. However, his public statements suggest he does not believe that the tax cut proposals which Prime Minister Berlusconi advocates are enough to spur economic development, and that the deficit reduction package and the budget must also create conditions for economic development - confidence in the economy and investment. On tax cuts, Siniscalco has hinted that if there were a "political" decision to go forward on the cuts, they might be implemented not before 2006 and perhaps over two years (with the subsequent need for even further deficit reduction). We also know he has committed to the unions not to cut health, education, social services, and homeland security. It will be interesting to see if these ideas take shape in the 2005 budget announced in September and if they survive the long parliamentary debate until the budget in finally passed in December.

Final Comment

¶18. Although just a planning document, the DPEF nonetheless indicates how the GOI might reconcile the somewhat contradictory goals of 1) achieving budget discipline to meet EMU requirements on budget deficits; and 2) stimulating growth. Italy's growth, though, is dependent not only upon budget discipline, but also on market liberalization. Thus, to raise itself from the unenviable position of having the lowest growth rate in the EMU area, Italy must also take the painful steps to privatize State firms and to liberalize its heavily-protected services sector and increase competition there, especially in the banking industry.

¶19. With the Government's formal presentation of the 2005 budget to the Parliament end-September, attention will shift again to Finance Minister Siniscalco. He will once again need to call upon his collaborative ways to open dialogue and convince both the major political parties and the social partners to bridge their differences and take the necessary steps to grow.

¶20. Finally, on privatization, the sale of Italy's State

assets may also open opportunities for U.S. investment banks, especially those now operating in Italy (Goldman Sachs, Merrill Lynch, JP Morgan, Morgan Stanley, Citigroup, and Lehman Brothers). End comment.

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